any other provision of federal law, including provisions of the Employee Retirement Income Security Act of 1974 (ERISA) administered by the Secretary of Labor.

Explanation of Provisions

The proposed regulations add a new paragraph to § 1.501(c)(5)–1 providing that an organization is not an organization within the meaning of section 501(c)(5) if the organization's principal activity is to manage savings or investment plans or programs, including retirement savings plans.

Proposed Effective Date

These regulations are proposed to be effective December 21, 1995.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) that are submitted timely to the IRS. All comments will be available for public inspection and copying. A public hearing may be scheduled if requested in writing by a person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the hearing will be published in the Federal Register.

Drafting Information

The principal author of these regulations is Robin Ehrenberg, Office of Associate Chief Counsel (Employee Benefits and Exempt Organizations). However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.501(c)(5)–1 is amended by:

1. Redesignating paragraph (b) as paragraph (c).

2. Adding a new paragraph (b) to read as follows:

§ 1.501(c)(5)-1 Labor, agricultural, and horticultural organizations.

* * * * *

(b)(1) An organization is not an organization described in section 501(c)(5) if the principal activity of the organization is to receive, hold, invest, disburse, or otherwise manage funds associated with savings or investment plans or programs, including pension or other retirement savings plans or programs.

(2) *Example.* Trust A is organized in accordance with a collective bargaining agreement between a labor union and multiple employers. Representatives of both the employers and the union serve as trustees. Trust A receives funds from the employers who are subject to the agreement, invests the funds and uses the funds and accumulated earnings to pay pension benefits to union members as specified in the agreement. It also provides information to union members about their retirement benefits and assists them with administrative tasks associated with the benefits. Most of Trust A's activities are devoted to these functions. From time to time, Trust A also participates in the renegotiation of the collective bargaining agreement. Because Trust A's principal activity is to manage funds associated with a pension plan, it is not an organization described in section 501(c)(5).

* * * * *

Margaret Milner Richardson,

Commissioner of Internal Revenue.

[FR Doc. 95–30830 Filed 12–20–95; 8:45 am]

BILLING CODE 4830–01–U

26 CFR Part 1

[EE–20–95]

RIN 1545–AT47

Effect of the Family and Medical Leave Act on the Operation of Cafeteria Plans

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations relating to cafeteria plans that reflect changes made by the Family and Medical Leave Act of 1993. The proposed regulations provide the public with guidance needed to comply with the Act and affect employees who participate in cafeteria plans.

DATES: Written comments and requests for a public hearing must be received by March 20, 1996.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (EE–20–95), room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (EE–20–95), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Catherine Fuller, (202) 622–6080; concerning submissions and the hearing, Mike Slaughter, (202) 622–8452 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed additions to the Income Tax Regulations (26 CFR Part 1) under section 125 of the Internal Revenue Code of 1986 (Code). These additions are proposed to conform the regulations to the Family and Medical Leave Act of 1993 (FMLA), Public Law 103–3. FMLA imposes certain requirements on employers regarding coverage, including family coverage, under group health plans for employees taking FMLA leave, and regarding the restoration of benefits to employees who return from FMLA leave. This notice of proposed rulemaking addresses a number of the principle questions that have been raised about how these FMLA requirements affect the operation of cafeteria plans (including flexible spending arrangements) maintained under section 125 of the Code. The rules in this notice of proposed rulemaking supplement the proposed Income Tax Regulations under section 125 of the Code. Except as otherwise provided in this notice of proposed rulemaking, all of the existing rules governing cafeteria plans, including the nondiscrimination rules, continue to apply.

The requirements pertaining to FMLA leave, including the employer's obligation to maintain coverage under a group health plan during FMLA leave and to restore benefits upon return from FMLA leave, are established by FMLA,

not the Code. The U.S. Department of Labor, in 29 CFR part 825, has published rules interpreting the requirements of FMLA, and the Department of Labor has jurisdiction relating to those rights or obligations. This notice of proposed rulemaking does not interpret FMLA; it provides guidance on the cafeteria plan rules that apply to an employee in circumstances to which FMLA and the Labor Regulations thereunder also apply. The Department of Labor has advised the Department of the Treasury, including the Internal Revenue Service (IRS), that the provisions of this notice of proposed rulemaking do not conflict with, and are not inconsistent with, the provisions of FMLA or the Labor Regulations thereunder.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Requests for a Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) that are submitted timely to the IRS. All comments will be available for public inspection and copying. A public hearing may be scheduled if requested in writing by a person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the hearing will be published in the Federal Register.

Drafting Information

The principal author of these regulations is Catherine Fuller, Office of Associate Chief Counsel (Employee Benefits and Exempt Organizations). However, other personnel from the IRS and Department of the Treasury participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par.Section 1.125–3 is added to read as follows:

§ 1.125–3 Effect of the Family and Medical Leave Act (FMLA) on the operation of cafeteria plans.

Q–1: *May an employee taking FMLA leave revoke an existing election of group health plan coverage under a cafeteria plan?*

A–1: Yes. An employee taking FMLA leave may revoke an existing election of group health plan coverage (including a health flexible spending arrangement (FSA)) under a cafeteria plan for the remaining portion of the coverage period. See 29 CFR 825.209(e). FMLA also requires that an employee be permitted to choose to be reinstated in the group health plan coverage (including a health FSA) provided under a cafeteria plan upon returning from FMLA leave if the employee's group health plan coverage terminated while on FMLA leave (either by revocation or nonpayment of premiums). Such an employee is entitled, under FMLA, to be reinstated on the same terms as prior to taking FMLA leave (including family or dependent coverage). See 29 CFR 825.209(e) and 825.215(d). However, the employee has no greater right to benefits for the remainder of the plan year than an employee who has been continuously working during the plan year. In addition to the rights granted under FMLA, such an employee has the right to revoke or change elections (e.g., because of changes in family status or significant cost or coverage changes imposed by a third-party provider) under the same terms and conditions as are available to employees participating in the cafeteria plan who are not on FMLA leave.

Q–2: *Who is responsible for making premium payments under a cafeteria plan when an employee on FMLA leave continues group health plan coverage?*

A–2: An employee is entitled to continue group health plan coverage (including a health FSA) during FMLA leave whether or not provided under a health FSA or other component of a cafeteria plan. See 29 CFR 825.209(b). An employee making premium payments under a cafeteria plan who chooses to continue group health plan coverage (including a health FSA) while on FMLA leave is responsible for the share of group health premiums that the employee was paying while working, such as amounts paid pursuant to a salary reduction agreement. The employer must continue to contribute the share of the cost of the employee's coverage that the employer was paying before the employee commenced FMLA leave. See 29 CFR 825.100(b) and 825.210(a).

Q–3: *What payment options are required or permitted to be offered under a cafeteria plan to an employee who continues group health plan coverage (including a health FSA) while on unpaid FMLA leave, and what is the tax treatment of these payments?*

A–3: (a) *In general* A cafeteria plan may, on a nondiscriminatory basis, offer one or more of the following payment options (subject to the limitations described in paragraph (b) of this Q&A–3) to an employee who continues group health plan coverage (including a health FSA) while on unpaid FMLA leave. These options are referred to in this section as pre-pay, pay-as-you-go and catch-up.

(1) *Pre-pay*. (i) Under the pre-pay option, a cafeteria plan may permit an employee to pay, prior to commencement of the FMLA leave period, the amounts due for the FMLA leave period. However, the Labor Regulations under FMLA provide that under no circumstances may the employer mandate that an employee pre-pay the amounts due for the leave period. See 29 CFR 825.210(c)(3) and (4).

(ii) Contributions under the pre-pay option may be made on a pre-tax salary reduction basis from any taxable compensation (including the cashing out of unused sick days or vacation days). These contributions will not be included in the employee's gross income, provided that all cafeteria plan requirements are satisfied. For example, see Q&A–5 of this section regarding restrictions on pre-tax salary reduction contributions when an employee's FMLA leave spans two cafeteria plan years.

(iii) Contributions under the pre-pay option may also be made on an after-tax basis. See Prop. Treas. Reg. § 1.125–1, Q&A–5.[1]

[1] Published as a proposed rule at 49 FR 19321 (May 7, 1984).

(2) *Pay-as-you-go.* (i) Under the pay-as-you-go option, employees may pay their share of the premium payments on the same schedule as payments would be made if the employee were not on leave or under any other payment schedule permitted by the Labor Regulations at 29 CFR 825.210(c) (i.e., on the same schedule as payments are made under the Consolidated Omnibus Reconciliation Act of 1985, Public Law 99–272; under the employer's existing rules for payment by employees on leave without pay; or under any other system voluntarily agreed to between the employer and the employee that is not inconsistent with this section or with 29 CFR 825.210(c)).

(ii) Contributions under the pay-as-you-go option are generally made by the employee on an after-tax basis. However, contributions may be made on a pre-tax basis to the extent that the contributions are made from taxable compensation (e.g., cashing out unused sick or vacation days) that is due the employee during the leave period, and provided that all cafeteria plan requirements are satisfied.

(iii) An employer is not required to continue the health coverage of an employee who fails to make required premium payments while on FMLA leave. See 29 CFR 825.212. However, if the employer chooses to continue the health coverage of an employee who fails to make required premium payments while on FMLA leave, the employer is entitled to recoup those payments as set forth in paragraph (a)(3)(i) of this Q&A–3. See also Q&A–6 of this section regarding coverage under a health FSA when an employee fails to make the required premium payments while on FMLA leave.

(3) *Catch-up.* (i) An employer that continues providing group health coverage to an employee who does not pay premiums on FMLA leave is, to the extent provided under the Labor Regulations, permitted to utilize the catch-up option to recoup the employee's share of premium payments. See, e.g., 29 CFR 825.212(b).

(ii) Where an employee is electing to use the catch-up option, the employer and the employee must agree in advance of the coverage period that: the employee elects to continue health coverage while on unpaid FMLA leave; the employer will assume responsibility for advancing payment of the premiums on the employee's behalf during the FMLA leave; and these advance amounts must be paid by the employee when the employee returns from FMLA leave.

(iii) Contributions under the catch-up option may be made on a pre-tax salary reduction basis when the employee returns from FMLA leave from any available taxable compensation (including the cashing out of unused sick days and vacation days). These contributions will not be included in the employee's gross income, provided that all cafeteria plan requirements are satisfied.

(iv) Contributions under the catch-up option may also be made on an after-tax basis. See Prop. Treas. Reg. § 1.125–1, Q&A–5.[2]

(b) *Exceptions.* Cafeteria plans may offer (pursuant to 29 CFR 825.210(c)) one or more of the payment options described in paragraph (a) of this Q&A–3, with the following exceptions:

(1) The pre-pay option cannot be the sole option offered to employees on FMLA leave. However, the cafeteria plan may include pre-payment as an option for employees on FMLA leave, even if such option is not offered to employees on non-FMLA leave-without-pay.

(2) The catch-up option can be the sole option offered to employees on FMLA leave if and only if the catch-up option is the sole option offered to employees on non-FMLA leave-without-pay.

(3) A cafeteria plan cannot offer employees on FMLA leave a choice of either the pre-pay option or the catch-up option without also offering the pay-as-you-go option, if the pay-as-you- go option is offered to employees on non-FMLA leave-without-pay.

(c) *Voluntary waiver of employee payments.* In addition to the foregoing payment options, an employer may voluntarily waive, on a nondiscriminatory basis, the requirement that employees who elect to continue health coverage while on FMLA leave pay the amounts the employees would otherwise be required to pay for the leave period.

Q–4: *Do the special FMLA requirements concerning an employee who continues group health plan coverage under a cafeteria plan apply if the employee is on paid FMLA leave?*

A–4: No. The Labor Regulations provide that, if an employee's FMLA leave is substituted paid leave as described at 29 CFR 825.207 and the employee continues group health plan coverage while on FMLA leave, the employee's share of the premiums must be paid by the method normally used during any paid leave (i.e., salary reduction). See 29 CFR 825.210(b).

Q–5: *What restrictions apply to contributions when an employee's FMLA leave spans two cafeteria plan years?*

A–5: (a) Contributions to a cafeteria plan during FMLA leave will not be included in an employee's gross income, provided that the plan complies with all cafeteria plan requirements. Among other requirements, a plan may not operate in a manner that enables employees on FMLA leave to defer compensation from one cafeteria plan year to a subsequent cafeteria plan year. See Prop. Treas. Reg. § 1.125–2, Q&A–5.[3]

(b) The following example illustrates this Q&A–5:

Example. Employee A elects health coverage under a calendar year cafeteria plan maintained by Employer X. A's premium for health coverage is $100 per month throughout the 12-month period of coverage. A takes FMLA leave for 12 weeks beginning on October 31 after making 10 months worth of premiums totalling $1000 (10 months × $100 = $1000). A maintains health coverage while on FMLA leave. A utilizes the pre-pay option by cashing-out A's unused sick days in order to make the required premium payments due while A is on FMLA leave. Because A cannot defer compensation from one plan year to a subsequent plan year, A may pre-pay the premiums due in November and December (i.e., $100 per month) on a pre-tax basis, but A cannot pre-pay the premium payment due in January on a pre-tax basis. If A participates in the cafeteria plan in the subsequent plan year, A must use another option (e.g., pay-as-you-go or catch-up) to make the premium payment due in January.

Q–6: *Are there special rules concerning employees taking FMLA leave who participate in health FSAs offered under a cafeteria plan?*

A–6: (a) *In general.* (1) A health plan that is a flexible spending arrangement (FSA) offered under a cafeteria plan must conform to the generally applicable rules in this section concerning employees who take FMLA leave. Thus, FMLA requires that an employee taking FMLA leave be permitted to—

(i) Continue coverage under a health FSA while on FMLA leave; or

(ii) Revoke an existing health FSA election under the cafeteria plan for the remainder of the coverage period. See 29 CFR 825.209(e).

(2) FMLA also requires the plan to permit the employee to be reinstated in the health FSA upon return from FMLA leave on the same terms as prior to taking FMLA leave. See 29 CFR 825.215(d) and paragraph (b)(2) of this Q&A–6. However, reinstatement is at the employee's election and under no circumstances may an employer require

[2] Published as a proposed rule at 49 FR 19321 (May 7, 1984).

[3] Published as a proposed rule at 54 FR 9460 (March 7, 1989).

an employee whose coverage has terminated while on FMLA leave to reinstate coverage under a health FSA upon return from FMLA leave. See 29 CFR 825.214(a).

(b) *Uniform Coverage Rule* (1) Q&A–7(b)(2) of § 1.125–2[4] (the uniform coverage rule) applies during the FMLA leave period as long as the employee continues health coverage. Therefore, regardless of the payment option selected under Q&A–3 of this section, for so long as the employee continues coverage (or for so long as the employer continues the coverage of an employee who fails to make the required contributions as described in Q&A–3(a)(2)(iii) of this section), the full amount of the elected coverage, less any prior reimbursements, must be available to the employee at all times, including the FMLA leave period.

(2)(i) If an employee's coverage under the health FSA terminates while the employee is on FMLA leave, the employee is not entitled to receive reimbursements for claims incurred during the period when the coverage is terminated. If that employee subsequently elects to be reinstated in the health FSA upon return from FMLA leave for the remainder of the plan year, the employee may not retroactively elect health FSA coverage for claims incurred during the period when the coverage was terminated. Further, the employee is not entitled to greater FSA benefits relative to premiums paid than an employee who has been continuously working during the plan year. See 29 CFR 825.216. Therefore, if an employee elects to be reinstated in a health FSA upon return from FMLA leave, the employee's coverage for the remainder of the plan year is equal to the employee's election for the 12-month period of coverage (or such shorter period as provided under § 1.125–2[5]), prorated for the period during the FMLA leave for which no premiums were paid, and reduced by prior reimbursements.

(ii) An employee on FMLA leave has the right to revoke or change elections (e.g., because of changes in family status) under the same terms and conditions that apply to employees participating in the cafeteria plan who are not on FMLA leave. Thus, notwithstanding the rules described in paragraph (b)(2)(i) of this Q&A–6, an employee who returns from FMLA leave may make a new health FSA election for the remainder of the plan year if return from leave without pay constitutes a change of family status under the employer's cafeteria plan.

(3) The following examples illustrate the rules in this Q&A–6:

Example 1: (a) Employee A elects $1200 worth of coverage under a calendar year health FSA provided under a cafeteria plan, with an annual premium of $1200. A is permitted to pay the $1200 through pre-tax salary reduction amounts of $100 per month throughout the 12-month period of coverage. A incurs no medical expenses prior to April 1. On April 1, A takes FMLA leave after making three months worth of contributions totalling $300 (3 months × $100 = $300). The plan does not permit a revocation of election on account of a change in family status. However, pursuant to A's rights under FMLA, A elects to terminate coverage upon going on FMLA leave. Consequently, A makes no premium payments for the months of April, May, and June, and A is not entitled to submit claims or receive reimbursements for expenses incurred during this period. A returns from FMLA leave and elects to be reinstated in the health FSA on July 1.

(b) Under FMLA, A has no greater right to benefits upon reinstatement than if A had been continuously working during the plan year. Therefore, A is reinstated to A's annual election (i.e., $1200) prorated for the period during the FMLA leave for which no premiums were paid (i.e., reduced for 3 months or ¼ of the plan year) less prior reimbursements (i.e., $0). Consequently, A's coverage for the remainder of the plan year equals $900. A must also begin making premium payments of $100 per month for the remainder of the plan year.

Example 2: Assume the same facts as *Example 1* except that A incurs medical expenses totaling $200 in February and obtains reimbursement of these expenses. The results are the same as in *Example 1*, except that A's coverage for the remainder of the plan year equals $700.

Example 3: Assume the same facts as *Example 1* except that prior to taking FMLA leave, A elects to continue health FSA coverage during the FMLA leave. The plan permits A (and A elects) to use the catch-up payment option described in Q&A–3 of this section, and as further permitted under the plan, A chooses to repay the $300 in missed payments on a ratable basis over the remaining six-month period of coverage (i.e., $50 per month). Thus, A's monthly premium payments for the remainder of the plan year will be $150 ($100 + $50).

Q–7: *Are employees entitled to non-health benefits while taking FMLA leave*?

A–7: FMLA does not require an employer to maintain an employee's non-health benefits (e.g., life insurance) during FMLA leave. An employee's entitlement to benefits other than group health benefits under a cafeteria plan during a period of FMLA leave is to be determined by the employer's established policy for providing such benefits when the employee is on non-FMLA leave (paid or unpaid). See 29 CFR 825.209(h). Therefore, an employee who takes FMLA leave is entitled to revoke an election of non-health benefits under a cafeteria plan to the same extent employees taking non-FMLA leave are permitted to revoke elections of non-health benefits under a cafeteria plan. For example, election changes are permitted due to changes of family status or upon enrollment for a new plan year. See § 1.125–2, Q&A–6(c)[6] and § 1.125–1, Q&A–8.[7] However, the FMLA regulations provide that, in certain cases, an employer may continue an employee's non-health benefits under the employer's cafeteria plan while the employee is on FMLA leave to ensure that the employer can meet its responsibility to provide equivalent benefits to the employee upon return from unpaid FMLA. If the employer continues an employee's non-health benefits during FMLA leave, the employer is entitled to recoup the costs incurred for paying the employee's share of the premiums during the FMLA leave period. See 29 CFR 825.213(b). In addition, a cafeteria plan must, as required by FMLA, permit an employee whose coverage terminated while on FMLA leave (either by revocation or nonpayment of premiums) to be reinstated in the cafeteria plan on return from FMLA leave. See 29 CFR 825.214(a) and 825.215(d).

Q–8: *How may taxpayers rely on these proposed regulations*?

A–8: (a) The guidance provided by the questions and answers in this section may be relied upon to comply with provisions of section 125 and will be applied by the Internal Revenue Service in resolving issues arising under cafeteria plans and related Internal Revenue Code sections. If final regulations are more restrictive than the guidance in this section, the regulations will not be applied retroactively. No inference, however, should be drawn regarding issues not expressly raised that may be suggested by a particular question or answer or by the inclusion or exclusion of certain questions.

(b) The Department of Labor has advised the Department of the Treasury, including the Internal Revenue Service, that the provisions of this section are not inconsistent with the provisions of

[4] Published as a proposed rule at 54 FR 9460 (March 7, 1989).

[5] Published as a proposed rule at 54 FR 9460 (March 7, 1989).

[6] Published as a proposed rule at 54 FR 9460 (March 7, 1989).

[7] Published as a proposed rule at 49 FR 19321 (May 7, 1984).

FMLA and the Labor Regulations thereunder.

Margaret Milner Richardson,

Commissioner of Internal Revenue.

[FR Doc. 95–30681 Filed 12–20–95; 8:45 am]

BILLING CODE 4830–01–U

26 CFR Part 1

[EE–106–82]

RIN 1545–AE45

Loans to plan participants

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed Income Tax Regulations under section 72(p) of the Internal Revenue Code relating to loans made from a qualified employer plan to plan participants or beneficiaries. Section 72(p) was added by section 236 of the Tax Equity and Fiscal Responsibility Act of 1982, and amended by the Technical Corrections Act of 1982, the Deficit Reduction Act of 1984, the Tax Reform Act of 1986 and the Technical and Miscellaneous Revenue Act of 1988. These regulations provide guidance to the public with respect to this provision, and affect any plan participant or beneficiary who receives a loan from a qualified employer plan.

DATES: Written comments and requests for a public hearing must be received by March 20, 1996.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (EE–106–82), Attention: Plan Loans Guidance, room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (EE–106–82), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Vernon S. Carter, of the Office of the Associate Chief Counsel (Employee Benefits and Exempt Organizations), IRS, at (202) 622–6070 (not a toll free number).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to the Income Tax Regulations (26 CFR Part 1) under section 72 of the Internal Revenue Code of 1986 (Code). These amendments are proposed to conform the regulations to section 236 of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), which added section 72(p) to the Code, and to the amendments to section 72(p) made by the Technical Corrections Act of 1982, the Deficit Reduction Act of 1984, the Tax Reform Act of 1986 and the Technical and Miscellaneous Revenue Act of 1988.

Explanation of Provisions

Section 72(p) of the Code generally provides that an amount received as a loan from a qualified employer plan by a participant or beneficiary is treated as received as a distribution from the plan for purposes of section 72 (a deemed distribution), except to the extent certain conditions are satisfied. For purposes of section 72, a qualified employer plan includes a plan that qualifies under section 401 (relating to qualified trusts), 403(a) (relating to qualified annuities) or 403(b) (relating to tax sheltered annuities), as well as a plan (whether or not qualified) maintained by the United States, a State or a political subdivision thereof, or an agency or instrumentality thereof. A qualified employer plan also includes a plan which was (or was determined to be) a qualified plan or a government plan. A loan from a contract purchased under a qualified employer plan is also treated as a loan from the plan. Section 72(p) also provides that an assignment or pledge of (or an agreement to assign or pledge) any portion of a participant's or beneficiary's interest in a qualified employer plan is to be treated as a loan from the plan.

Under section 72(p), a loan from a qualified employer plan to a participant or beneficiary is not treated as a distribution from the plan if the loan satisfies certain requirements relating to the terms of the loan and the repayment schedule, and to the extent the loan satisfies certain limitations on the amount loaned. The proposed regulations require that the loan be evidenced by an enforceable agreement, set forth in writing or in another form that is approved by the Commissioner of Internal Revenue, that includes terms that satisfy the statutory requirements. Thus, the agreement must specify the amount of the loan, the term of the loan, and the repayment schedule. The agreement may be set forth in more than one document.

If a loan fails to satisfy the repayment requirements or the enforceable agreement requirement, the proposed regulations provide for the balance then due under the loan to be treated as a distribution from the plan. This may occur at the time the loan is made or at a later date if the loan is not repaid in accordance with the repayment schedule. If the loan satisfies the repayment requirements and the enforceable agreement requirement, but at the time the loan is made the amount of the loan exceeds the statutory limitation on the amount that is permitted to be loaned, the proposed regulations provide that only the excess amount is a deemed distribution.

One of the repayment requirements is that the loan be repaid within five years, unless the loan is used to acquire a dwelling unit which within a reasonable time is used as the principal residence of the participant. The proposed regulations provide that a principal residence has the same meaning as under section 1034 (relating to the taxation of a sale of a residence) and that tracing rules established under section 163(h)(3)(B) (relating to interest deductions for indebtedness incurred with respect to the acquisition of a principal residence) will be used to determine whether the section 72(p)(2)(B)(ii) exception to the five-year repayment requirement applies. (Notice 88–74 (1988–2 C.B. 385), sets forth certain standards applicable under section 163(h)(3).)

The Tax Reform Act of 1986 amended section 72(p) to require that, in order for a loan to not be treated as a distribution, the loan must be repaid in substantially level installments (not less frequently than quarterly) over the term of the loan. Section 72(p) authorizes regulations to allow exceptions from this requirement. Pursuant to this authorization, the proposed regulations permit loan repayments to be suspended during a leave of absence of up to one year, if the participant's pay from the employer is insufficient to service the debt, but only if the loan is repaid by the latest date permitted under section 72(p)(2)(B).

If the repayment terms of a loan are not satisfied after the loan has been made due to a failure to make a scheduled loan repayment, the proposed regulations provide for the balance then due under the loan to be deemed to be distributed. The proposed regulations permit a grace period, to the extent the grace period does not extend beyond the end of the calendar quarter next following the calendar quarter in which the repayment was scheduled to be made.

If a loan is treated as a distribution under section 72(p), the proposed regulations state that the amount so distributed is to be treated as a taxable distribution, subject to the normal rules of section 72 if the participant's interest in the plan includes after-tax contributions (or other tax basis). A deemed distribution would also be a distribution for purposes of the 10